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March 13, 2006

AGENDA ITEM 9a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Currency Strategic Plan
- II. PROGRAM:** Currency Overlay
- III. RECOMMENDATION:** Information Only
- IV. ANALYSIS:**

Background:

- In 1991, Bill Sharpe and Wilshire were involved in the initial study of what portion of international assets (hedge ratio) should be hedged for CalPERS' international portfolio. Using different methodology, Bill Sharpe and Wilshire came to a similar conclusion that the hedge ratio should be static and approximately 25% over international equity.
- Equity and fixed income were the only two international assets in CalPERS' portfolio in 1992.
- It was then believed that equity managers, unlike fixed income managers, tended to focus on micro rather than macro economic issues, hence equity managers did not have the skill set to manage currency. Therefore, only CalPERS' international equity investments would be hedged.
- Guidelines for the currency overlay program (the program) determined that the primary objective is to provide risk control, or a reduction in the volatility of the returns from the CalPERS' international equity investments while return was given a secondary consideration.
- On November 13, 2000, approval was granted by the Investment Committee (IC) to proceed with a passive currency overlay strategy to be managed internally by CalPERS staff. It was anticipated that staff would gain greater insight into currency overlay program as a whole.

- At the October 28, 2004 Asset/Liability Management Workshop staff presented a primer on the currency overlay program. Staff committed to bring forward considerations for the evolution of the program.
- For the December 13, 2004 meeting, staff presented an information agenda item with three new ideas to enhance the program and solicit feedback.
- The IC gave staff the ability to manage the hedge ratio tactically within bounds of +/- 5% of the targeted hedge ratio of 25% at the April 18, 2005 meeting.
- As of January 31, 2006 the size of the currency overlay program (the Program) was approximately \$10.7 billion.

Attached is the CalPERS Currency Vision for the future (Attachment 1). The presentation:

- Outlines plans
- Considers currency's role in a portfolio
- Reviews CalPERS currency experience
- Provides an overview of active currency strategies

The critical content of the presentation are the following:

1. CalPERS has had a successful currency program
2. Existing programs should remain unchanged
3. That staff is working toward an internal active currency alpha program
4. Currency risk should be considered at the overall CalPERS portfolio level which will be presented at the 2007 Asset Allocation Workshop
5. Staff will continue to inform and work with Wilshire on all aspects of the currency program.

V. STRATEGIC PLAN:

Monitoring and review of the Currency Overlay Program is consistent with CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Costs associated with CalPERS currency overlay program are the external manager fees, staff salaries and support systems. The changes envisioned are suggested to improve the cost effective return on CalPERS portfolio.

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